china's regulations offer first time opportunities

Large amounts of inbound investment, speculative funds and trade surpluses have raised China's foreign-exchange reserves to $483 billion as of mid-2004. As a result, China has recently announced rules to make it easier for Chinese companies to invest overseas and expand internationally. "Even though China is the world's largest recipient of direct foreign investment, the amount invested by Chinese companies abroad is comparatively small," says Steve McCullough, business manager Asia Ex Japan/Australia, JPMorgan Investor Services, Asia Pacific (APAC). However, the recent regulatory developments are expected to change that.

> **"While it is difficult to predict the ultimate impact these regulatory changes might have on China's market, we do anticipate that continued relaxation of restrictions is likely."**

"Until recently, access to China's capital markets was limited to only a few options," says McCullough. "In the past, investors mainly had access through Red Chips in Hong Kong (China-controlled firms with mainland assets), or the B share market in the Shenzhen Stock Exchange (SZSE) and the Shanghai Stock Exchange (SHSE)," he says. In addition, the creation of the QFII (Qualified Foreign Institutional Investors), allowed foreign investors access to the Chinese A share and debt markets for the first time. As of November 2004, China had approved 21 QFII investors, at a total investment limit of $3 billion.

China's Investment Options Expand

However, more recently, China's investment menu has expanded to include not only investment into China, but also QDII investors (Qualified Domestic Institutional Investor), which allows China's institutional investors to invest in offshore markets for the first time. "There was much speculation in the press around this issue," McCullough says. "Some thought that China's National Social Security Fund would be the first institution to invest overseas," he says. However, it was China's insurance companies that were initially approved under the *Temporary Measures on Overseas Use of Foreign Exchange Funds Regulation*[1] issued by the Chinese Insurance Regulatory Commission (CIRC) and the State Authority for Foreign Exchange (SAFE).

Custodians play an important role in this new regulation. "QDII status for Chinese insurance companies will likely result in opportunities for global custodians and our clients; providing opportunities for assets to be held in global pools in multiple jurisdictions and segregated portfolio management," McCullough explains.

Chinese officials have drafted the regulations to ensure that the assets and records of investment activity by insurance company clients are retained and available to them. As a result, the insurer's domestic custodian is required to hold a local domestic custody license and, on a

1. Foreign exchange funds refers to the aggregate capital, common reserves, undistributed profits and guaranteed deposits, received by an insurance company that are denominated in foreign exchange.

regular basis, to report on the overseas investment activities of the insurance company to both the CIRC and SAFE on the remittance of capital to and from China.

"We believe this particular requirement only relates to the investment activities of the insurance companies in line with their investment objectives and not a broader requirement to police their general activities," says McCullough. The regulators, however, are very interested in learning about the role of a trustee and as a result we will discuss the activities of JPMorgan in other locations where the trustee function is embedded within the market structure, such as in the U.K.

Under the new regulations, the insurance segment is permitted to invest up to $9 billion in overseas assets. "The decision was largely driven by the successful overseas listing of Chinese insurance companies in the U.S. and Hong Kong," McCullough explains. Those companies include: China Life Insurance Co., PICC Property & Casualty Co. (China's largest general insurer), and Ping An Insurance Group Company of China. Further scope was built into the regulations to allow Sino-foreign joint ventures or a branch of a foreign insurance company approved by the CIRC.

China's Insurance Companies Must Meet Certain Criteria Before Being Permitted to Invest Offshore:

1. Must have a permit for conducting foreign exchange business;

2. The company's total assets at the end of the previous year must not be less than rmb 5 billion;

3. Foreign exchange funds at the end of the previous year must not be less than $15 million or equivalent value in a freely convertible currency;

4. The company's solvency margin complies with relevant stipulations of the CIRC;

5. The company has a specialized fund use department or a relevant insurance asset management company;

6. Internal management and risk control systems must comply with the stipulations of the risk control guidelines for use of insurance funds;

7. The number of professional managerial personnel with over 2 years' overseas investment experience must comply with relevant stipulations; and

8. Other qualifications specified by the CIRC and the SAFE.

Requirements for Overseas Investment Institutions:

1. A company will be permitted to conduct asset management business according to the law of the country or region where it is located;

2. A company's risk control indexes shall comply with the law of the country or region where it is located and with relevant regulations of its supervisory authority;

3. Neither the company's paid-up capital nor its net assets shall be less than $60 million or equivalent value in a freely convertible currency. The amount of assets under its management shall not be less than $50 billion or equivalent value in a freely convertible currency;

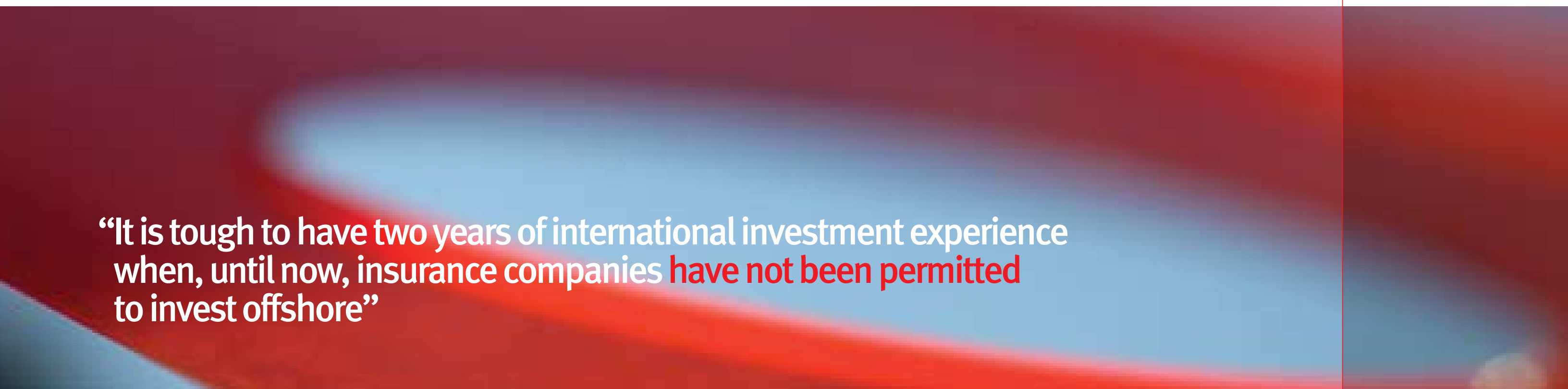
4. A company should have a sound corporate governance structure, a good and complete internal management system and a good and complete risk control mechanism with no record of serious violations of laws or regulations in the country or region where it is located in the last three years;

5. A company must have over 10 years of business experience in international asset management with a corresponding number of professional investment personnel;

6. A company shall make a written commitment to truthfully provide transaction information about overseas use of foreign exchange insurance funds as required by the CIRC when necessary;

7. The country or region where the company is located shall have a sound financial supervision system. Its financial supervisory authorities shall have signed memorandum of understanding for supervision cooperation with Chinese financial supervisory authorities and keep effective cooperative relationship in respect of supervision with their Chinese counterparts; and

8. Other requirements specified by the CIRC on the principle of prudence.



According to McCullough, insurance companies have been establishing asset management companies to support their own investment activities and may also eventually be allowed to manage assets on behalf of other insurance companies as well. "Additional regulations have also been passed permitting the insurance companies themselves to invest directly into the domestic capital markets, where in the past, they were limited to mutual funds and bank deposits," McCullough adds. In addition to increased market liquidity, the regulations offer China's insurance companies the opportunity for further diversification and the potential for increased returns.

Insurance Companies Invest Offshore

Under the new regulations, insurance companies are permitted to appoint overseas institutions to act as investment managers. Given the regulations' requirement that professional managers must have over two years of investment experience, there could be significant opportunity for separately managed portfolios. "Because the market has been closed, experience levels in the industry are relatively low. It is tough to have two years of international investment experience when, until now, insurance companies have not been permitted to invest offshore," he says. Interestingly, resumes of such staff are required to be submitted to the regulators as part of the application process.

The investment scope, if released as expected, will be fairly restricted and limited to:

- Bank[2] deposits; bonds of foreign governments, international financial organizations;
- Foreign companies' bonds[3] that the Chinese government or Chinese enterprises issue overseas;
- Money market[4] products including bank bills and negotiable certificates of deposit; and other investment objects and instruments within the scope specified by the state council.

McCullough says, "While it is difficult to predict the ultimate impact this regulatory change might have on China's market, we do anticipate that continued relaxation of restrictions is likely. With further investment flows out of China through the gradual roll out of QDII mechanism, the amount of offshore insurance assets should likely double within the next one to two years. We look forward to supporting this new and exciting segment and to continue to play a supporting role to regulators and market participants alike." ○○○

Currently, there are three JPMorgan Chase bank branches in China, in Beijing, Tienjian and Shanghai. For more information on investing in China, contact Steve McCullough at (852) 28001800.

2. "Bank" refers to an overseas branch of a Chinese commercial bank or a foreign bank with long-term credit rating of "A" or above granted by an internationally recognized rating institution in the past three years.

3. Bonds refer to the bonds with credit rating of "A" or above granted by an internationally recognized rating institution.

4. Money market products refers to money market products with regular earnings and a AAA rating or equivalent granted by an internationally recognized rating institution.